THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 350 **JULY 2002**

…the difficulty always lies in supplying the means of production, not in stimulating the desire for consumption; and we have seen that production alone furnishes the necessary incomes to spend. Thus, it is the aim of good government to stimulate production, of bad government to stimulate consumption.

Jean-Baptiste Say, *A Treatise on Political Economy*
(First published in French in 1803)

U.S. ECONOMIC WRECKAGE EXPOSED

The financial markets are typically considered leading indicators of the economy, and with good reason. They form an important transmission mechanism through which monetary policy impacts the economy. Typically, at the dawn of a new economic cycle, rising stock and bond prices allow companies to replenish cash holdings and strengthen balance sheets.

Yet this time it is different. Despite a flood of money and credit creation, and despite widespread predictions of recovery, the markets refuse to cooperate.

Why? In short, because we are not experiencing a cyclical recession, and therefore a cyclical recovery is not on the way. Instead, the U.S. economy is *sick to the bone*.

Unprecedented excesses in consumption and financial speculation have devastated the growth fundamentals of the U.S. economy, as evidenced by the deplorable state of savings, capital investment and profits.

Worse, the gross macro- and microeconomic mismanagement that caused the current economic sickness was sold to the public as a new paradigm economy that would deliver unprecedented miracles of productivity growth and profits. Yet it only delivered unprecedented fraud and abuse in various forms — from manipulated government statistics to rigged corporate profit reports.

Yet deception and mismanagement have apparently lost their power to sustain the illusion of economic health. Loose monetary policy is having no impact, major corporations have been caught committing egregious fraud and no amount of government massaging of the numbers can patch up widespread deteriorating profits.

The markets are not rallying… the recovery is not under way. Instead, the bear market and a major recession are only just beginning.

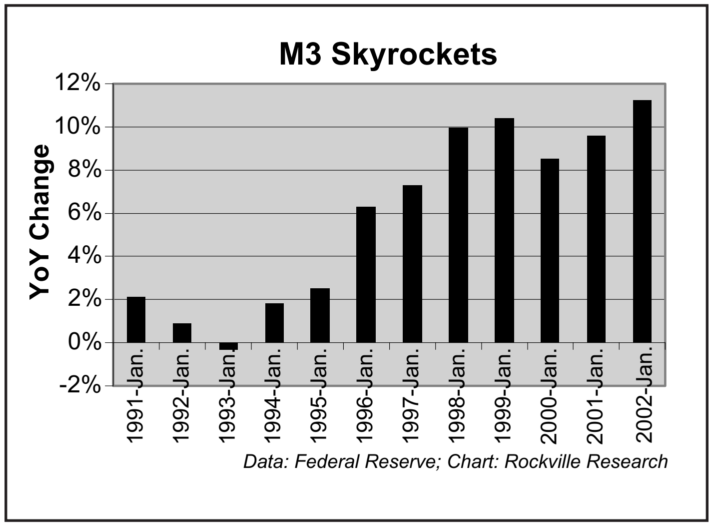
UNCOOPERATIVE MARKETS

At the start of the year, most strategists predicted strong gains for equities, expecting that a U.S.-led world economic recovery would feed through to sharply higher corporate profits. Yet today, Japan's Nikkei is where it started the year, while the principal German and U.S. equity indices are down 9% and 13% and the Nasdaq is down another 20% since the beginning of the year — 70% from its high just over two years ago.

Even though the data seem to confirm the optimistic forecasts of the U.S. economy's recovery, there has clearly been a pronounced shift in the performance of the stock market for the worse. The post-Sept. 11 rally gains have all but vanished. What has triggered this change in direction?

For most people, and for Wall Street experts in particular, this savage bear market in stocks is incomprehensible. Looking for an explanation, they cite all kinds of events, such as terrorist threats, geopolitical uncertainty, fears of war between Pakistan and India or tensions in the Middle East. Strikingly common to all these explanations is the failure or refusal to see the main culprit: grave problems in the U.S. economy itself.

In the consensus view, all the crucial monetary and economic conditions for a repeat of the typical, cyclical bull run of the stock market have been splendidly fulfilled. Greenspan's rate cuts were the most aggressive in postwar history, and money and credit growth has continued to run rampant.



For the first time in the postwar period, monetary easing — even the most aggressive easing in the Fed's history — is proving a flop in kindling a stock market rebound. According to press reports, the gains in stock prices during 16 different easing periods have averaged 14.9% after nine months and 20% after 20 months. Yet today the Dow is down over 10% in the 18 months since the Fed started easing, the S&P 500 is down over 20% and the NASDAQ is down nearly 40%.

LOOSE MONEY AND CREDIT FAIL TO STIMULATE THE MARKETS *AND* THE ECONOMY

To find a parallel to the present experience, where even the most drastic monetary easing is followed by a slumping stock market, it is necessary to go back to 1930. But saying this, we must also draw attention to an ominous *difference* between then and today.

In 1930, outstanding U.S. broad money shrank 2% in the course of the year. For the 12 months ending in the first quarter of 2002, it surged by 9.9%, or $724 billion. But consider that today's heady money growth compares with measly nominal GDP growth of $289.6 billion for the year through the first quarter. Total credit, meanwhile, expanded over the same period by $1,711.5 billion, including an $863.7 billion increase in nonfinancial credit and an $847.8 billion jump in financial credit.

There is a widespread view that this prodigal money and credit creation is a great positive for the economy and the financial markets. In our view, it is ominous when such inordinate monetary expansion has such minimal effects on the economy and the financial markets.

Imagine, over one full year, one dollar added to GDP was matched by 5.9 dollars added to debts! We are not quite sure what is really the more frightening scenario: the slight monetary shrinkage in 1930 or the lavish money and credit growth of 2001-02 that mostly goes up in smoke.

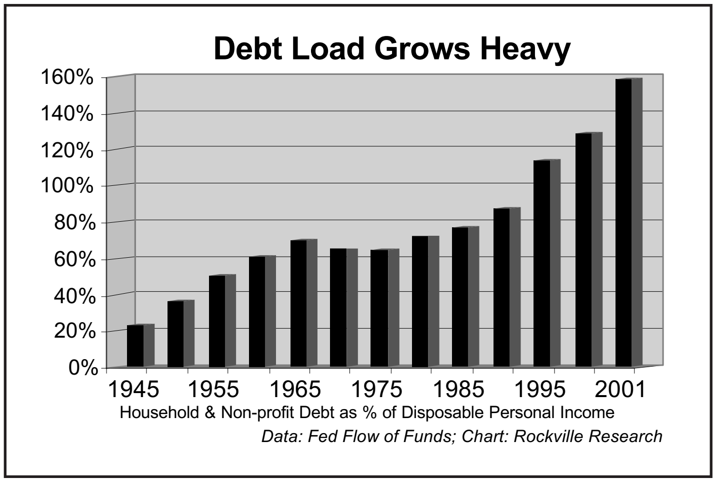
Scrutinizing the credit figures, we note moreover a feature that appears to us equally foreboding: total business borrowing has virtually collapsed.

BUSINESSES RETRENCH, CONSUMERS SPLURGE

Total business borrowing edged up in the first quarter at an annualized rate of $127.4 billion versus increases of almost $600 billion in 1999 and 2000. *Corporate* debt growth, meanwhile, fell even more sharply. After averaging annual increases of about $400 billion during 1998-2000, it increased at an annual rate of just $12.6 billion in the first quarter.

The extreme opposite is, of course, the consumer's financial behavior. With new consumer borrowing running at $695 billion during the first quarter of 2002, he broke all past records. This compares with a prior peak of $614.6 billion in 2001. For perspective, these debt figures must be weighed against woefully slow income growth.

Total consumer income grew at an annual rate of $110.7 billion in the first quarter of 2002. This represents a virtual collapse from gains of $541.9 billion in 2000 and $404.3 billion in 2001. Wages and salaries, meanwhile, crept up an annual rate of $31.8 billion in the quarter, a sharp deceleration from a gain of $365 billion in 2000 and $261 billion in 2001. That is, businesses have cut spending on labor even more fiercely than their investment spending.



The discrepancy between income and debt growth has become unbelievable. In 2001, disposable personal income growth of $386.3 billion was topped by new debts of $614.6 billion, making for a ratio of new debt to new income of 159%. During the bubble years 1995-2000, private households piled up $2,164 billion of new debts on an increase in disposable income of $1,675 billion, equaling a debt-to-income ratio of 129%, after 114% during the first half of the decade.

There is quite a fuss about rising house prices enriching the consumer and enabling him to keep up his extraordinary borrowing and spending binge. First of all, reasonable policymakers and people ought to wonder about the quality and sustainability of such economic growth. Besides, the plunging stock market is impoverishing private households a lot faster, and with a lot more to come, in our view. According to the latest Fed data, the stock market losses amount — so far — to more than $4 trillion, or roughly 40% of GDP.

Recessions are periods during which the excesses and maladjustments that have accumulated during the prior boom are purged. Fed Chairman Alan Greenspan's unrelenting monetary looseness represents a desperate attempt to sustain consumer-spending excesses. He certainly realizes that any serious retrenchment by the consumer will pull the rug out from under the economy. In effect, though, this policy only buys time while making the inevitable final bust all the worse.

DANGEROUS IMBALANCES

What, then, is the cause of this economic downturn? First the short answer: a variety of appalling imbalances and dislocations that the monstrous credit excesses of recent years, egged on by the prolonged, steep rise in stock prices, have inflicted on the economy and its financial system.

In a world where macroeconomic thinking has been generally abolished, there is little or no understanding of such a statement. The one and only economic maladjustment that American economists can think of are rising inflation rates. Those being absent, nothing else matters in their eyes: not the soaring debt levels of consumers and businesses, the collapse of national saving, or the explosion of the trade deficit. Grotesquely, many economists rather hail these dangerous maladjustments as hallmarks of the U.S. economy's outstanding health and strength.

As a matter of fact, the emphasis on "imbalances" as causes of recession also used to be colloquial thinking for American economists. In an essay published in 1975, Raymond J. Saulnier, former chief economist for President Eisenhower, wrote, *"expansionist policies when carried to excess result not only in an outbreak of inflation but in structural imbalances that sooner or later make recession a virtual certainty."* Economists of the time generally understood and fully accepted this key postulate of Austrian economics.

Symptomatic of today's general incomprehension of macroeconomics is a narrow-minded concern with undifferentiated aggregates, like GDP, credit, money supply and income. But economic problems generally arise from major shifts within these aggregates, for example from shifts between consumption and investment or between profits and wages. Or in the case of credit, the crucial factor is often not changes in quantity but changes in their use.

What, then, is a *structural imbalance that sooner or later makes recession a virtual certainty"?* A closer loser look at the changes in the composition of GDP explains it. We emphasize that we regard the years from 1997 to 2001 as the decisive phase of self-destruction for the U.S. economy. The decisive culprit was Mr. Greenspan, hailed and admired by the whole nation and the rest of the world.

VANISHING SAVINGS

The most visible maladjustment in the economy is the crash of net private savings, first of personal savings and then of business savings. For the fourth quarter of 2001, the national income accounts show personal savings of $27.9 billion and business savings (undistributed profits) at -$3.5 billion, both at annual rate. Aggregate net private savings thus amounted to $24.4 billion. This is virtually zero, compared to a total of about $473 billion in 1997.

This raises two questions: first, how does this compare with the past? Second, does it matter?

To answer the first question, these numbers compare abysmally with the past. Over the whole postwar period until 1982, the net savings rate of the private sector had averaged 7.9% of GDP. It suffered its first sharp decline during the 1980s, falling to about 4.5% of GDP. Then, in the wake of a sharply rising budget deficit, national savings fell to an unprecedented low of 2.5% of GDP. At the time, this plunge of domestic savings effectively caused alarm and a heated debate among American economists.

The present collapse of private savings eclipses the savings downturn of the 1980s. However, nobody seems to care this time. Rather, the economic and political establishment is united in pleading with the consumer *not to let up* on his massive dissaving! At the same time, economists are falling over themselves to explain that there is no problem.

PRIVATE SAVINGS COLLAPSE (BILLIONS $)

	1997	1998	1999	2000	01Q1**	01Q2**	01Q3**	01Q4**
PERSONAL SAVINGS	252.90	301.50	160.90	67.70	78.80	81.50	285.30*	27.90
BUSINESS SAVINGS	220.00	133.60	179.80	104.30	113.70	98.00	55.20	-3.50
TOTAL	472.90	435.10	340.70	172.00	192.50	179.50	340.50	24.40
GDP	8,159.50	8,508.90	8,856.50	9,224.00	10,141.70	10,202.60	10,224.90	10,263.30
PRIV. SAVINGS AS % OF GDP	5.8%	5.1%	3.8%	1.9%	1.9%	1.8%	3.3%	0.2%

*due to a big tax cut **Quarterly figures for 2001 are annualized.
Source: Commerce Dept., Survey of Current Business

The main reason that personal savings took this steep fall is undisputed. It was the inordinate escalation of consumer borrowing, plainly propelled by the "wealth effects" of prolonged sharp rises in stock and housing prices. Private consumption grew an average of 5.1% a year from 1997 through 2001, far faster than the 3.1% average annual increase of GDP.

This implied a drastic change in the composition of GDP. Taking a rapidly growing share of demand and output, personal consumption accounted for *108% of GDP growth* during these years, by far its highest rate in history. The crucial point to see here is that such a steep decline in savings is not just a money problem. Inherently, it has led to a drastic shift in the economy's whole demand and output structure.

As to the simultaneous steep fall of business savings, it has accrued mainly from the fact that corporations, in the face of sliding profits, have increasingly funded their sharply rising dividend payments at the expense of retained earnings, ravaging their cash flow. The compounded effect of personal and business dissaving is the steepest decline of national savings ever, far steeper than in the 1980s.

THE MOST OUTRAGEOUS BUBBLE IN HISTORY…

The first thing to get straight is that this was — and still is — the most outrageous bubble economy in history, far worse than the U.S. bubble of the 1920s and Japan's bubble of the late 1980s. This term implies that rising asset prices fuel an extraordinary burst in spending, either through soaring wealth effects on consumption or through sliding capital costs on investment. In the U.S. case, the bubble-related spending went fully into private consumption.

Effectively, Mr. Greenspan's prolonged, extreme monetary looseness created multiple bubbles both in the

U.S. economy and in its financial system. The most obvious and spectacular among them was certainly the Nasdaq bubble. ***But the biggest and most terrifying bubbles are the consumer bubble, the bond bubble and the dollar bubble.***

All three have yet to pop, and when they do, they will wreak unprecedented havoc on the whole U.S. financial system because all three of them are addicted to permanent, limitless debt creation. Eventually, a point is reached where the financial system is unable to create the ever-greater credit requirements to keep these bubbles expanding.

…AND A BUBBLE OF ECONOMIC IGNORANCE

This total carnage of national savings is the U.S. economy's most important — but also most widely ignored — predicament. But policymakers and most economists seem to lack any understanding or appreciation of its grave implications that this infers for economic growth and financial stability in the longer run.

It has become the general, complacent mantra that consumer finances are in far better shape than the miserable saving figures suggest because the official income figures wrongly exclude the huge capital gains that have accumulated from rising stock and house prices. Even a recent study by the Federal Reserve Bank of New York argued on this same line, calling the Commerce Department's savings gauge *"a very distorted measure"* of consumer finances that doesn't say much about America's ability to keep on spending.

Yet, above all, policymakers should *at least* get the definition of savings correct.

Ever since Adam Smith, savings has meant exactly one and the same thing in all languages: it is the part of current income that is not spent on consumption. And the key point of this definition is that such savings, and such savings only, make it possible to divert real resources from the production of consumption goods to the production of capital goods.

To pin down and emphasize the key point: savings from current income represent the economy's supply of capital. Thus, it definitely sets the limits to the financial funds and the real resources that are available for new capital investment. Any increase in consumer spending as a share of GDP correspondingly decreases the economy's capacity for capital formation. It is, of course, easy to replace missing savings with credit creation. But there is no substitute for missing real resources.

NO SAVINGS, JUST LEVERAGE

In fact, U.S. stock and credit markets in the past few years have boomed and expanded on a scale never before experienced. Since current savings collapsed, it is self-evident what supplied the overabundant fuel for this unprecedented stock and debt orgy — Mr. Greenspan's wide-open money spigots fostering unlimited and uncontrolled financial leveraging.

As already mentioned, such ravage of domestic savings had a precedent in the 1980s. Then too, despite the rhetoric, the actual result of the trumpeted supply-side policies was an unprecedented, sharp decline of national savings.

Supply-siders predicted that President Reagan's tax cuts would boost savings and investments. Instead, household savings sharply dropped as the rising stock market induced consumers to an extraordinary borrowing and spending binge. Personal consumption as a share of GNP rose temporarily to 74%. Yet the largest contribution to the savings slump came from a soaring federal budget deficit. What happened was the exact opposite of the supply-side premises: a consumption boom at the expense of investment and the trade balance.

Net national savings — personal and business savings minus the government's budget deficit — fell during the 1980s to their lowest level in the postwar period, equaling 2.5% of GNP, after averaging almost 8% of GNP between 1948-82.

As available resources are limited, the goods to meet the pressing consumer demand have to be drawn from

somewhere else. There are, essentially, two potential sources: foreign trade and a lower net investment ratio. In the 1990s just as in the 1980s, the consumption boom translated into an exploding trade deficit and a declining ratio of net business fixed investment, hitting in particular net investment in manufacturing.

But in the 1980s, there still existed a clear understanding — also among American economists — of the adverse macroeconomic implications of sharply lower savings for capital formation and economic growth. At the time their reckless ravage provoked highly critical comments, mostly from academic America, but also from official sources such as the Federal Reserve Bank of New York. Today, however, the N.Y. Fed distinguishes itself with articles that dismiss near-zero savings as a statistical distortion.

Actually, the ravage of savings and capital formation in the later ’90s has definitely been far worse. Nonetheless, we note with amazement that concern and criticism are virtually absent this time. The main culprit during the 1980s was the surging budget deficit, while net private sector saving, though substantially reduced, remained well above 4% of GNP. This time, total private sector saving has effectively crashed to zero, as evident in the table on page 4. That is, the culprits this time are businesses and the consumer.

LOOMING TROUBLE ALSO ON THE FISCAL FRONT

Not only that, growing trouble for savings is now looming on the fiscal front. In complete disregard of collapsing tax revenues, President Bush and Congress have jointly engaged in a wild spending spree both for defense and nondefense.

In the first quarter of 2002, the federal government ran a deficit of $112 billion at annual rate, versus a surplus of almost $300 billion in 2000. That represents a negative swing of more than $400 billion within barely two years. Some of it reflects the economy’s weakness. But most of it is the deliberate fruit of tax and spending policies.

Here, too, nobody seems to care. We wonder, by the way, about the costs of a war against Iraq.

Looking at diametrically opposite trends in tax receipts and expenditures, the safest thing to predict is that the government’s budget deficit will surge. Coming on top of zero savings on the part of businesses and consumers, net national savings are essentially headed into negative territory. The last time this happened was in the Great Depression of the 1930s.

We presume that growing desperation in Washington over escalating economic/financial troubles is also driving this hectic fiscal expansion. At any rate, massive fiscal stimulus has been added to unprecedented money and credit creation. Yet to little visible avail. Many people seem to be impressed by the economy’s resilience. We regard it as ominous that such massive monetary and fiscal stimulus has such minimal effect.

The news that U.S. real GDP grew 5.6% in the first quarter was immediately hailed as conclusive evidence of a beginning strong recovery. Looking at the details, we could only wonder. Never forget, first of all, that these numbers are annualized. Above all, however, its composition was very dubious. No less than 62% of the real GDP growth accrued from lower inventory growth, another 22% from higher government spending and the rest came from rich hedonic pricing of computers. To call this a cyclical recovery is ridiculous.

ILL-STRUCTURED INVESTMENT PATTERN

We come to the major structural distortions and dislocations that have badly undermined the U.S. economy’s fundamental health. National savings in total have been squandered to pay for spending that the consumer cannot afford from his current income. Such massive dissaving is a profoundly destructive phenomenon. The inherent damage to the economy’s whole structure arises from the fact that it fosters an ill-fated, unsustainable diversion in the economy’s whole demand and output structure towards consumption at the expense of investment.

It was a main piece of the New Economy hype that American corporations had embarked on their greatest investment boom of all times, in particular in the new information high tech, accounting for more than one-third of real GDP growth. For us, observing the soaring share of consumption, this proclaimed investment boom was highly suspect right from the beginning.

As we have been stressing for years, the alleged record investment boom that the GDP figures seemed to show owed its beauty overwhelmingly to the phony hedonic pricing of computers. Measured in money terms, the annual growth rate of business fixed investment actually slowed during the 1990s from 8.9% in the first half to 8.5% in the second half. But in real terms, owing largely to the hedonic pricing, the average annual growth rate sharply accelerated from 5.5% in the first half to 14% in the second half.

What's more, the investment pattern was grossly ill-structured. Vastly excessive investment into producing high-tech equipment concurred with grossly lacking investment in conventional industrial equipment. The expected and trumpeted profit miracle to be derived from producing and using high-tech equipment never materialized. Temporarily high profits derived mainly from the booming stock market. Poor profits from producing high-tech equipment have turned into a profit implosion.

Another snag in the investment pattern is that the consumer's borrowing and spending binge fuelled a wave of investment in stores across the retail industry. The amount of store space dedicated to selling goods grew four times faster than the U.S. population in the second half of the 1990s.

PRODUCTIVITY GROWTH, STUPID

All in all, the new paradigm economy has miserably failed by all accounts. Since there is little left to boast about, the reported stellar productivity growth has become the favorite topic in the economic discussion. Mr. Greenspan and numerous economists keep emphasizing that this is the single most important factor affecting the economy's performance.

It strikes us in the first place that the stellar productivity growth that has been reported for the past several years has apparently failed to exert any of the great, beneficial effects generally ascribed to it. Why should it do wonders in coming years?

Second, we have to point out that the high esteem of today's American economists for productivity growth is unique. In conspicuous contrast, there is very little about it in the writings of the old economists. Even Joseph Schumpeter, in his large opus about business cycles, never mentions it. Why this silence? The old economists were, of course, fully aware of the importance of productivity growth. But regarding it as the dependent variable of capital accumulation, they focused on the key conditions fostering and allowing for a high rate of capital accumulation: savings, profits and investment.

In the end, in fact, it is all about capital investment. It is the critical mass in the process of economic growth that generates all the things that make for rising wealth and living standards. Capital investment creates demand, employment, income, profits and tangible wealth while the buildings, plants and equipment are produced. And with their installment, these capital goods create growing supply, productivity, employment, incomes and profits that, by the way, also repay the debts.

Strictly speaking, productivity growth is an abstract quantity that, by itself, creates neither demand nor supply and neither income nor profits.

WHAT IS AILING THE STOCK MARKET?

The big new theme about the U.S. economy is the protracted fall of the stock market, which caught most people by surprise. For the first time, an apparent economic recovery lacks the company and, above all, support of sharply rebounding financial markets. Actually, the markets typically surge well before the recovery shows in the economic data. Sharply rising bond and stock prices are, in fact, a very important part of the transmission mechanism through which monetary easing impacts the economy.

Everything is different this time. Why? All earlier recessions had their immediate cause in monetary tightening that forced businesses and consumers to retrench. Doing so, they reliquified their strained balance sheets and created pent-up demand that would serve as the launching pad for the following recovery. As soon as the central bank loosened its monetary reins, the economy would promptly take off.

But present economic and financial conditions are diametrically different. The Fed never tightened. It kept the money and credit spigots wide open and eased with unprecedented aggressiveness as soon as the economy showed the first signs of slowing. It succeeded in supporting consumer spending, but it totally failed to prevent a drastic retrenchment of businesses in their spending on investment and employment. And the reasons for that retrenchment are well known: not only the unprecedented profits slide but also extremely strained balance sheets.

Pondering the further development of the U.S. economy and its stock market, we focus on two different influences: drastic changes for the worse in underlying market conditions, and drastic changes for the worse in the economy's whole warp and woof.

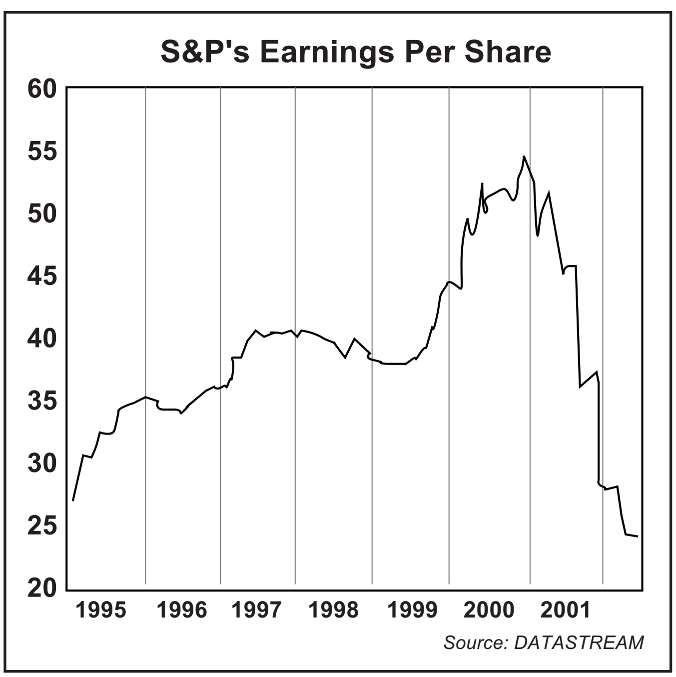
BLIND TO THE BUBBLE

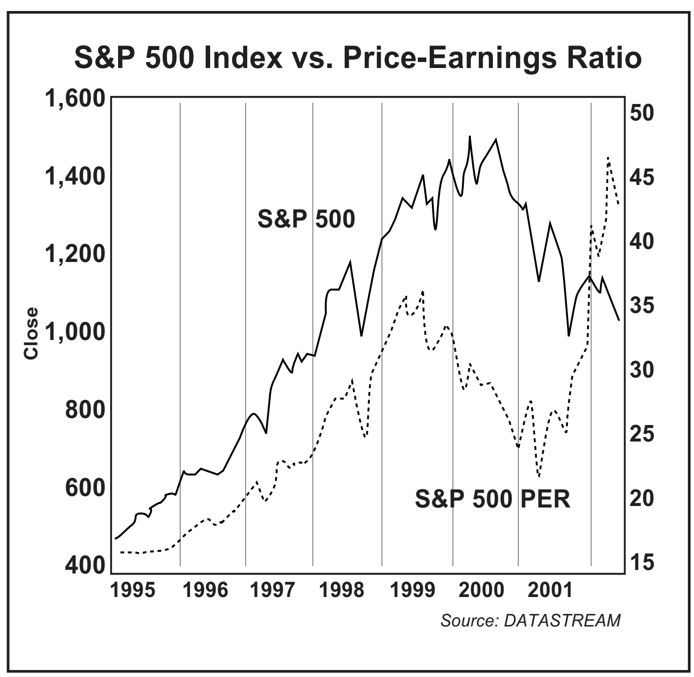
What, then, is driving the U.S. stock market downward? Is it mainly an unjustified bout of pessimism, or is it hard, negative facts about the markets and the economy?

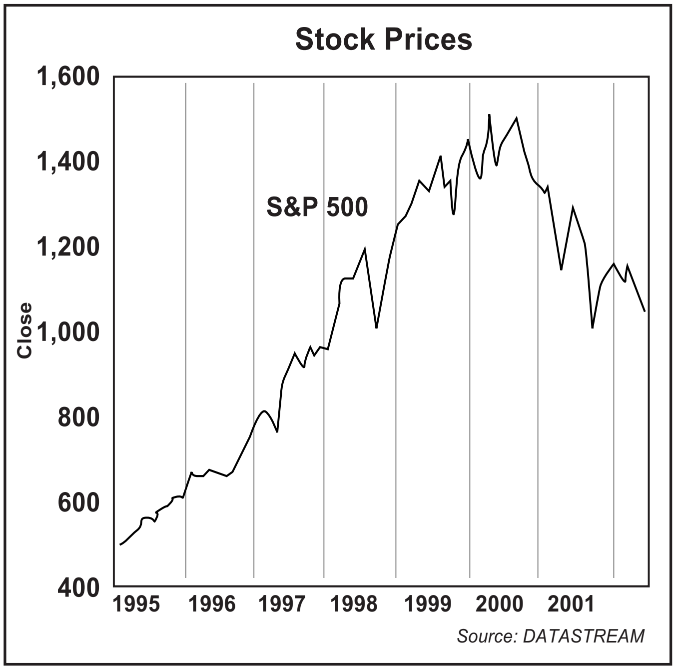
For sure, the former euphoria about economic miracles has largely given way to some disenchantment. Yet from what we mostly read and hear (on television), we note a striking absence of serious anxiety. Considering the pervasiveness of fraudulent accounting by corporations that is coming to light, we find the backlash in the markets — in stocks, bonds and currencies — amazingly weak and slow in coming. While investors might have become nervous, they are apparently still very bullish for the longer run.

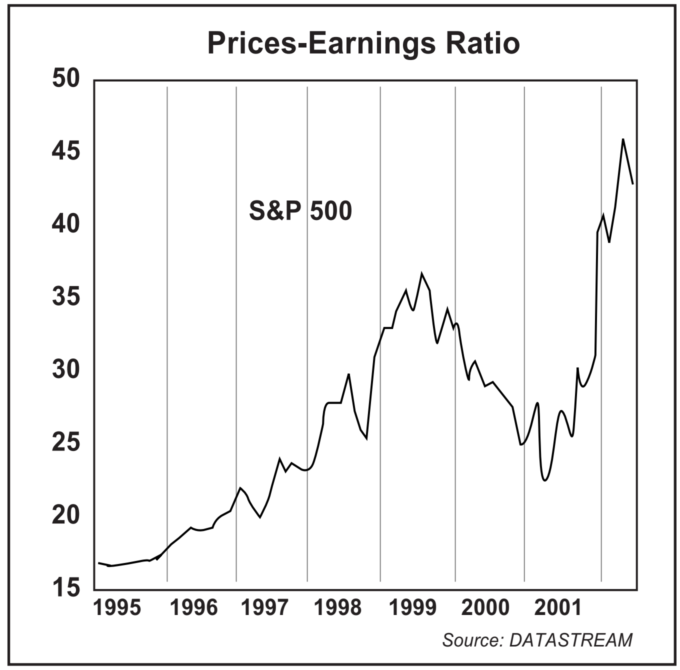
True, stock prices have taken a steep fall, but stock valuations — measured by price-earnings ratios — remain sky-high by traditional measurement. The charts below pinpoint the two reasons for the strange phenomenon: business profits have fallen much faster than stock valuations, resulting in surging stock valuations.

Rationally, these sky-high market valuations of U.S. stocks make sense only in expectation of an impending steep rise in business profits. To us, therefore, they essentially reflect underlying, still rather high-riding, long-term optimism about the U.S. economy, rather than any pessimism. In fact, the prevalent profit forecasts appear absurdly unrealistic to us.









What, then, is preventing the U.S. stock market from staging its typical, cyclical rebound? The short answer is: The sliding market has been ravaging corporate, institutional and individual investors of wealth and cash. Considering all circumstances, the surprising thing is not the lack of buying but the lack of heavier selling.

To bear in mind, key drivers of the past bull market were, actually, American corporations, buying for mergers, acquisitions and stock buybacks, and foreign corporations, buying for direct investment. Together, the two have in 1999 and 2000 been net buyers of U.S. equities by well over $400 billion per year.

The mere discontinuation of the former large-scale stock purchases of these two groups goes a long way to explain a virtually endless bear market for U.S. stocks. In reality, there lurks still another major menace from the supply side of the stock market. That's a huge overhang of outstanding stock options that are successively ending their lockup periods and becoming free for sale.

Now to the decisive point: Except for the formerly huge stock purchases by corporations and foreigners, the U.S. stock market's performance has become entirely dependant on purchases from the domestic investment community, that is, on private households and pension funds.

Despite plunging savings, they, too, have drastically increased their stock holdings in the past few years. Why not this time? In the face of falling markets, grossly overweighed stock holdings rather suggest some selling; and second, further stock purchases depend, after all, on nonexistent new saving.

LACKING INVESTMENT FUNDS

In actual fact, the supply of new savings derives from two sources. One is the portion of personal current income that private households do not spend on consumption. The other source is the cash contributions of corporations and employees to their joint pension schemes.

Years ago, these so-called institutional savings accounted for about half the flow of recorded personal savings in America. But this formerly large part of current savings vanished during the 1980s, as the developing bull market increasingly funded corporate pension plans with soaring capital gains. This caused the first big dent in the U.S. personal savings rate. Yet it had another, widely unappreciated, effect as well.

Since pensions ceased to cost companies any money, profits were boosted. What's more, soaring stock prices allowed numerous companies to bolster their profits with realized capital gains of their pension funds that had in this way become "overfunded." According to Salomon Smith Barney, 11% of the operating profits of "overfunded" companies in 2000 came courtesy of pension stock market gains.

One would think two years of falling stock prices would have stopped this practice. But don't underestimate the determination of American corporations to please investors with good-looking profit numbers. In pursuit of this noble aim, corporate profit trickery has moved to new and higher levels. It is now perfectly legitimate to turn effective pension fund losses into actuarial phantom pension income.

According to a report in the *New York Times*, a study by Millmann USA, a benefits consulting firm, found that the reported results of 50 large companies in 2001 included $54.4 billion of profits from pension fund investments. In reality, these pension funds had lost $35.8 billion. The losses are buried in annual report disclosures that few can understand.

The New York Times report mentions a particular case, that of Verizon Communications, Inc. The company reported an income of $1.8 billion from its pension fund last year, even though it had in reality incurred a loss of $3.1 billion. Verizon simply assumed that the asset holdings of its pension fund would earn on average an annual return of 9.25%, and it reported income as if that assumption were true, something it is able to do under current accounting rules.

The general, comforting assumption, of course, is that this gap in balance sheets will be filled sooner or later by a new rise of stock values. We have no doubt that the gap will soar due to sliding stock values.

Yet in recent years private households, pension funds and insurers, too, have been purchasing stock vastly in excess of new savings inflows. They could do so by switching out of other investments. But the result is in general grossly overweighed stock holdings, implying growing pressure to sell. False hopes for a recovery of the economy and the markets are keeping many stockholders from immediately selling. One day, they will sell at any price.

Summing up, domestic investors across the board — corporations, institutional investors and private households — are financially tapped out. Private and corporate balance sheets are at their weakest in history. Foreign investors face the double whammy of losing on falling stock prices and a falling dollar. The surprising thing under these conditions is not that stock purchases have dramatically declined but how much buying still continues.

CRISIS IN PROFITS…

Putting it bluntly, market conditions are horrible. But what kind of influences are to be expected from the economy? What is happening in the economy that will, one way or another, influence sentiment in the stock market?

For us, the single most important question of all is the immediate and longer-term profit prospects. There is a widespread perception in America that rising consumer demand is the key condition to induce businesses to invest. In the tradition of European economics, we stick to the view that the one, decisive moving force in every capitalist economy is the expectation of profit.

America, evidently, has the most buoyant consumer demand in the world, but it fails to elicit domestic production and investment because Corporate America doesn't see the profits that it wants. Thus, consumer demand emigrates.

Assessing actual corporate profit prospects in America, we first focus on the two major sources of business sales and revenues. The latest available number is for March, and that was well below the number for January. Its main components are consumer spending and business spending. Considering all circumstances, it seems a

safe assumption that consumer spending is sure to slow down from its recent hectic pace. Just as sure, this is going to hurt profits.

But while consumer spending draws all the attention, far more important in particular from the profits perspective is business spending on fixed investment. This has its reason in the fact that — looking at the business sector in the aggregate — business investment spending increases business revenues but not business costs.

Put differently, business capital spending increases the revenues of the firms that produce the capital goods. On the other hand, the firms that buy the capital goods incur no expenses because they capitalize their investment spending. Related expenses arise gradually when the depreciation charges set in. Owing to this specific treatment of capital expenditures in balance sheets, net fixed investment is typically the single largest macroeconomic profit source.

…AND A CRISIS IN CAPITAL FORMATION

Our earlier central contention was that in the end the economic growth process is all about capital investment. The same, as just explained, is true for profit creation. For the reasons explained, net investment is the most important profit source. Yet there is always a circular causation. High capital investment breeds high profits, and high profits, in turn, breed high capital investment.

Pondering the prolonged, poor profit performance in America, we see its decisive, primary cause in gross corporate mismanagement. In their frenzied pursuit to enrich themselves and their stockholders in the quickest way possible, American corporations in the past few years have massively resorted to mergers, acquisitions, stock buybacks and cost-cutting, sold to the public as measures providing new paradigm synergy effects.

While the effect on stock prices couldn't have been more spectacular, the inherent erosion of the economy's growth fundamentals, showing in the dismal development of savings, capital investment, profits and the trade balance, was flatly ignored or discarded as economically irrelevant in comparison to the alleged profit and productivity miracle. It was economic intelligence at its lowest in two centuries.

The big short-run gains in share prices were, in reality, achieved at the expense of capital investment. Instead of new factories, the enlightened CEOs built in the course of their financial wizardry unprecedented mountains of new debt. Knowing the crucial importance of net new capital investment, it was clear to us right from the beginning that the strategies implicit to this new "equity culture" would devastate profitability in the long run.

Capital investment, as elucidated, is the key strategic variable in the economic growth process. But its realization depends on two indispensable preconditions: an expectation of reasonable profits; and command of sufficient financial resources through saving from current income.

The intriguing thing about the U.S. economy is that both requisite conditions for capital formation have been systematically destroyed in the past few years. Savings have been wiped out by gross macro-mismanagement, more precisely, by the preposterous credit excesses fuelling consumption and speculation; and profits have been depressed by gross micro-mismanagement, favoring financial manipulation to sound capital investment.

The crucial thing to see about the U.S. economy is that its growth during the past few years was driven by uncontrolled debt creation for consumption and financial speculation, while in the process domestic savings and the potential for capital investment have been devastated as never before.

STRAPPED OF CASH AND PROFITS

We recently received the latest Flows of Funds Accounts from the Federal Reserve through the first quarter

of 2002. It lured us into taking a closer look at the table for "Nonfarm Nonfinancial Corporate Business," and we found a few remarkable things.

First of all, between 1996-2000, corporate fixed investment increased by 43% to $911 billion, from where it fell until the first quarter of 2002 to $820 billion. Annual growth averaged 5.7%.

Second, capital consumption allowances, however, soared by 65.5%, or 13.1% per annum, owing to sharply increasing short-lived high-tech investment.

Third, this coincidence of sharply falling investment spending and soaring capital depreciation expenses is distinctly the single worst depressant of profits. As to capital spending, the result was collapsing net corporate capital investment. After peaking in 2000 at a level of $251.5 billion, it went negative in the fourth quarter of 2001 for the first time in the postwar period. That is, Corporate America is investing less than its capital depreciations. Seeing no change in this respect, we see no change in profits for the better.

Fourth, the misguided corporate strategies of the past few years inspired by the equity cult have, last but not least, ravaged corporate balance sheets and cash flow. Both are at their worst in the whole postwar period.

CONCLUSIONS:

Very few people so far have realized that the U.S. economy is sick to the bone. In the past few years it has been grossly mismanaged, on the macro level through unprecedented monetary looseness on the part of the Greenspan Fed, and on the micro level through corporate strategies that built only mountains of financial leveraging but no factories.

Healthy, long-term economic growth depends on three key fundamentals: savings, profits and capital investment. During the past few years in the United States, all three have been devastated in favor of debt-fuelled consumption and financial speculation. It is becoming evident that the new paradigm economy was a new paradigm sham.

Looking at the plunging stock market, it seems that the moment of truth for the economy and the markets is rapidly approaching. Yet, we still have the impression that there is more confusion than serious worry about what is happening in the economy and the stock market. Inevitably, the consumer, too, will have to retrench. This recognition will pull the rug from under the economy, the markets and the dollar.

The dangers that loom on the currency front are immense. Virtually, the grossly overleveraged U.S. financial system is hostage to a strong dollar and permanent, huge capital inflows. The U.S. trade deficit and the accumulated foreign indebtedness have reached a scale that defies any possible action by central banks. The fate of the dollar is out of any control.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by The Fleet Street Group
Laura Davis, Group Publisher
Doug Noland, Market Analyst
Jeanne Smith, Marketing Manager
Brian Flaherty, Design & Layout

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling 1-800-433-1528, or from outside the U.S. by calling (508) 368-7498. Fax (410) 454-0403. Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.